THE WAY TO ATTAIN AND MAINTAIN MONETARY REFORM IN LATIN-AMERICA

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For many years the names of certain countries of Latin-America were synonymous in the public mind with paper inflation and dubious finances. This stigma the more progressive countries have in recent years been rapidly casting off. They have in some cases, where they had been saddled with debt without receiving an adequate return, made equitable readjustments, as in the cases of Santo Domingo, Honduras, and Costa Rica. They have in other cases raised their credit to the point where their securities sell nearly on a parity with those of leading European countries, as in the cases of Brazil and the Argentine Republic.

The reform of the fiscal affairs of a government which has been in difficulties is perhaps a wise preliminary to reform in the monetary system; but in a sense the monetary reform transcends in importance the fiscal reform. Fiscal reform means the restoration of a favorable balance to the budget and the prompt payment of interest on public obligations. Monetary reform reaches deeper into the heart of commercial affairs, because it alone makes possible the free interchange of products and the investment of foreign capital upon a basis which ensures its permanency in gold value.

Capital shrinks from a country without a monetary standard based upon gold, because both the principal and the dividends to be remitted to gold countries may shrink radically in gold value with the depreciation of the local currency. On the other hand, a country whose currency system is based upon the gold standard is able not only to attract capital for permanent investment, but also its share of the great circulating loan fund which is available for equalizing rates for money and meeting unexpected demands by its free movement between the financial centers. It was pointed out in the report of the Commission on International Exchange, when Mexico was still on the silver basis, that Mexican bankers had sufficient credit to borrow money in Paris, Berlin or Brussels in large amounts

and make seven, eight, or ten per cent on the investment, but did not dare to do so, because if it was loaned on short-time and they were called on to repay it, the fluctuations in the gold value of the silver currency might more than wipe out all their profit.[1]

The importance of offering inducements for the inflow of foreign capital has evidently been obtaining recognition in recent years in Latin-America and is bringing about measures to restore the currency to a gold basis in those countries which have been increasing their production of goods for export and thereby strengthening their credit position abroad. Steps towards monetary reform have been taken within the past fifteen years by the Argentine Republic, Brazil, Peru, Ecuador, Bolivia, and other countries.

It will not be disputed that, in the effort to return to a sound monetary system in any of these countries, it is of the highest importance that the method chosen should be, if possible, the most economical, the most certain to maintain permanently the gold standard, and the most likely to afford a supply of currency adequate for local needs. The question naturally presents itself whether the methods which are being pursued or considered are the best for the accomplishment of these purposes. If they are not, why not? And, also, if there are better methods, what are those methods?

The science of maintaining an adequate stock of currency upon principles at once economical and safe has been until recently in its infancy. It was enough for early economists of the school of Ricardo, that a currency consisting of gold coin ensured the full intrinsic value of the national circulation, and afforded the means of maintaining stable exchange. Much has been learned in currency matters within the last few decades, especially in regard to the regulation of foreign exchange. Most of the monetary systems created since 1890 have depended in some degree, as in the case of British India, the Philippines, Mexico, Russia, and Austria-Hungary, upon the control of the market for exchange. In this field experience has developed what is substantially a new monetary system, known as the gold exchange standard.

What is this gold exchange standard, which was adopted by the Congress of the United States for the Philippine Islands and was made the foundation of Finance Minister Limantour's reform of the monetary system in Mexico? It may be briefly defined thus:

[1]See the author's "Principles of Money and Banking," Vol. I, p. 353.

The maintenance of silver coins at parity with gold, without reference to their bullion value, by restriction of the quantity to the requirements of local trade and by the sale of bills of exchange on exchange funds deposited abroad, at legal gold parity, plus such legitimate charges for exchange as prevail between gold countries.

Wherein does this system differ from the simple gold standard? And wherein is it more suitable for the undeveloped countries?

The difference between the exchange standard and the simple gold standard is the extension of the banking principle to the foreign exchanges. Under the exchange system the gold which is needed for settling foreign balances is kept in foreign financial centers instead of at home and a "gold export" or "gold import" movement is accomplished by the transfer of drafts instead of boxing up and shipping physical gold. From this system flow important economic advantages, beyond the mere economy in freight and express charges, which can perhaps be better brought out by a study of recent monetary history than by stating them in abstract form.

Among the South American countries which have taken steps towards the restoration of stability to their monetary systems within the past dozen years, have been Brazil and the Argentine Republic. These countries have been especially fortunate in the volume and value of the exports of their principal products,—coffee, sugar, wheat and hides. This has enabled them to draw gold in large amounts from Europe and North America. Under the monetary system which has prevailed for several years in these two countries, the gold has been accepted by the conversion funds in exchange for paper at a fixed rate of exchange. Up to a very recent date, gold has not been freely paid by the conversion offices for the redemption of paper. The value of the paper has been maintained by the fact that the accretions to existing issues have been covered fully by gold, and the need for this additional currency has been indicated by the willingness to buy it with gold.

From this standpoint, of the demand for currency, it might be said that even the paper which was not covered by gold, issued prior to the creation of the conversion funds, also represented just the amount of currency which the country was then able to employ in its exchanges, when taken at the gold value to which it had been reduced in use. In the case of over-issues of irredeemable paper, there is usually a tendency, others things being equal, for the gold

value of the paper to fall in the ratio of its excess above the amount of gold currency required for doing business.[2]

Among the factors which cause a variation from this ratio are the degree of credit in which the paper is held from time to time, the fluctuations caused by the demands for foreign exchange, and the possibility of ultimate redemption at any given rate. In the case of the Argentine Republic, the value of 44 gold centavos for 100 paper centavos, which was adopted as the gold value of new paper to be issued by the conversion office, was about the value of the paper at the time when the fund was established, and may, according to the above rule, be considered as representing, at its gold value, the amount of currency then demanded by the business of the country.

Now that gold is to be paid in these countries for paper, apparently without premium or other restraint upon its issue, it becomes an interesting problem whether difficulties will arise in keeping gold in the country. The merit of the system of a pure gold currency is that it leaves unhampered to the conflict of individual initiative throughout the world the movement of gold and credit. The tendency of such a system is to send gold to those communities which, by reason of their wealth, have the largest surplus available for investment in a metallic currency and have the most frequent use for gold. Unfortunately for the countries of less financial power, the tendency of this free play of economic forces is to draw gold away from them to those countries which are economically stronger. This fact has been demonstrated repeatedly in monetary experience and has extended to the further application, that any currency, whether of coin or paper, issued by a governing country, when put in circulation in a dependency, tends to return to the mother country and denude the dependency of an adequate supply of monetary signs.

The operation of this principle, of the drainage of gold, has been witnessed not only in the case of countries essentially poor, but even in those of large resources where a country of stronger resources has possessed the same monetary system. This has been the history of the Latin Monetary Union, where the coins of each country have

[2]Thus in Brazil, the 297,800,000 milreis in paper in circulation in 1890 was worth more in gold than the 788,364,000 milreis which had been forced into circulation in 1898. *Vide* the present writer's "History of Modern Banks of Issue," Fourth Edition, p. 501.

common currency in the others. This has facilitated such a steady drainage, first of gold and ultimately of silver, from Belgium and Switzerland into France, that it has been repeatedly urged by responsible economists that Belgium and Switzerland should withdraw from the Latin Union and establish each for herself a currency which should be to some degree under her own control and not subject to free exportation by individuals for an insignificant profit and independent of the legitimate demands for exchange. In the case of Brazil and the Argentine Republic, one of the factors which has drained Belgium and Switzerland of their gold will be lacking,—uniformity of the currency with that which circulates in other countries. The Argentine Republic acted wisely, from this point of view, in rejecting the proposal to adopt a unit of the same value as the franc, which might have led to the draining away of her gold coins to France and other countries of the Latin Union.

The reason for the disappearance of gold from countries which are not the centers of exchanges is found in the principle of economic selection, otherwise described as the law of marginal utility. To the individual desiring foreign products, gold in his hands is the most convenient means of obtaining them. He parts with gold because his need for it is less intensive than for the goods, but in so doing he deprives the community of metallic currency. So long as the control of the supply of metallic currency, therefore, is left in such communities to the play of individual initiative, gold tends to disappear.

It is at this point that the advantages of the exchange standard reveal themselves. The government has the same interest and economic sanction for taking measures to maintain a local currency, adequate to the needs of the country, which it has for doing other things, like the provision of water supply and sewerage, which are not sufficiently the interest of a single individual to insure their being done by him, but which are of essential value to the community as a whole. Upon the individual trader there is no responsibility, except his own convenience, to contribute a share of his capital sufficient to afford an adequate circulating medium for the country; but the government, viewing broadly the need for such a medium for the promotion of mercantile exchanges and the development of the natural resources of the country, may justly decide to devote a certain portion of the national capital to the maintenance of a sound and suitable currency.

In the ideal financial world, gold should be permitted to move freely from one country to the other with the smallest possible obstacles except those set up by changes in the rate of discount. It has come to be recognized, however, in recent years, as the result of the experience of British India, Chile and other countries, that the obstacles of a variation in monetary units and in legal tender laws, and restraints upon the free delivery of gold for export may contribute their share in checking the adverse current of the foreign exchanges, without violating sound economic principles. The protection afforded by the exchange standard to the monetary system is indeed only a variation and extension of those methods of foresight, management of the discount rate, and accumulation of foreign bills which are now recognized everywhere as the legitimate weapons of the central bank of issue, charged by law or financial public opinion with the function of safeguarding the national credit.

The principles of the gold exchange standard have been in operation in British India since about 1899; in Peru since 1901; in the Philippine Islands since 1903; in Panama since 1904; and in Mexico since 1905. Such dangers as were feared at first in its operation have been met and overcome or have been proved to be mythical. The supreme test of the system took place in British India as the result of the crop failures of the spring of 1908, which deprived the country to a large degree of the means of meeting its foreign obligations by the sale of bills against the exportation of its products. The result of this test was that the reserve fund of about $90,000,000 held in London for the protection of $600,000,000 in Indian currency was reduced about one-half by the sale of drafts in India upon this fund. The silver coins paid for these drafts were locked up in the Indian Treasury until the time came for the revival of Indian agriculture and trade and the demand for an increase in the circulation. This demand was met by renewed sales in London of drafts on the Indian Treasury, which drafts were paid off in India in the local currency, which was thus restored to active local use.

The principle of the gold exchange standard is the same which has governed banking operations during the past century,—the existence of an adequate reserve in gold or gold credits to maintain a credit circulation. One of the important questions which was put to the test in this experiment in British India was how far an adverse balance of foreign trade or other unfavorable circumstances

may reasonably be expected to go in their demands upon the exchange fund. The mathematical answer in this case was the ratio of $50,000,000 to $600,000,000, or about eight per cent. Obviously a country will not part with all its currency in order to meet obligations abroad, even if there are no obstacles in exchange rates to check the free flow of coin; and much less is it likely to do so if such obstacles exist. The suggestion that demands upon the exchange funds could reach such a limit, or the half of it, is parallel with that of the novice, without knowledge of banking history, who enquires what would happen to a bank if all its depositors should demand currency for their deposits on the same day. Experience rather than abstract possibilities has determined the attitude of the financial world towards these questions. In the case of a token currency of silver, however, diffused over an entire community, the position is much stronger than in the case of a single bank, with a circulation largely local and subject to the possibilities of sudden distrust. It is not merely that the national currency commands greater confidence, but that it constitutes the sole medium of exchange. Even if depreciated, experience has shown that a currency will continue to be employed for the necessary transactions of daily life, while in the case of a single bank it might be conceivable that all its circulating notes could be withdrawn from circulation without impairing to any noticeable degree the means of exchange in other forms of currency at the command of the community.

Thus there has been evolved the principle that the demands upon an exchange fund arising from the transfer of capital, adverse exchanges, or even distrust, are limited to a small proportion of the total volume of the currency of the country. The experience of British India in 1908, when the contraction which was expressed in the demand for exchange on London amounted to about eight per cent of the estimated total circulation of the country, may not be the ultimate limit of possible demands upon a reserve fund in case of financial calamity,—indeed there is no means of fixing an arbitrary limit. That test was a very severe one, however, and took place in a country where the token coinage had been accumulating for generations to an amount which could not even be accurately ascertained. In any such test in a country which deliberately adopts the exchange standard hereafter, a reserve will be created in advance adequate to meet probable demands as determined by statistics ap-

proximately accurate of the amount of coins issued, the amount exported or consumed in the arts, and the amount actually in banks or in circulation at any given moment. The statistical problem will be comparatively simple, except in the case of ignorant hoarding of the coins, because the difference between their face value and their bullion value will prevent any considerable consumption in the arts or exportation as bullion. If hoarding occurs in spite of the credit element in the value of the coins, it will only reduce by its gross amount the net circulation to be protected by the gold exchange fund.

No burden of permanent indebtedness or of annual interest payments is required for launching and maintaining the gold exchange standard. If conducted purely as a government operation, as was the case in the Philippine Islands, a temporary advance of funds is necessary for purchasing and carrying the silver bullion until it is converted into coin and put in circulation. When once in circulation, however, the amount expended for bullion would be reimbursed by the new coins and a profit of from 30 to 40 per cent of the face value of the coins would remain to be covered into the gold reserve. In other words, the coin would pay for itself in much the same manner as the minting of gold under free coinage. The difference would be that in the case of the silver coins issued under the exchange standard, their deficiency in intrinsic value would be made up by the seigniorage profit, which would be set aside as a gold reserve.

If the transaction were entrusted to bankers willing to make the preliminary advances for the purchase of bullion and to assume all the expenses of coinage and expert services necessary to put the system in operation, the bankers could be compensated by an equitable division of profits between the government and themselves, without reducing the gold reserve below the point of safety. Indeed, in the case of a comparatively small country, if the bankers themselves were the custodians of the reserve, they would undoubtedly be able and willing to take any necessary steps to maintain parity in case of unusual drafts upon the reserve fund, so long as the government concerned was performing its part in good faith and was maintaining civil order.

Inter armis silent leges. The gold exchange standard, in case of an upheaval which wrecked the finances of a country, would not

operate very differently from any other form of currency. If the currency of a country under such conditions were gold coin, it would be exported or hoarded. If it were paper, it would drop to unknown depths. If parity could not be maintained under the exchange standard, the coins would tend to fall to their bullion value in silver.[3] Undesirable as such a consummation would be, it would be much better than the unfathomable depth to which a paper currency would fall.

It is not necessary here to enter in detail into the processes by which a new coinage based upon the exchange standard would be put in circulation. If the government were redeeming depreciated paper at a fixed rate, the new coins would be exchanged for the paper at their gold value. If the existing currency of the country consisted of foreign coin or paper, for which the government was not responsible, such currency when received for public dues would be disposed of to the best advantage through the banks and the foreign exchanges and the new currency would be disbursed for the obligations of the state. In either of these cases, if considerable amounts of the old currency were in the keeping of the banks, they would be permitted to exchange the old for the new on equitable terms or would be left free to export the foreign currency and to substitute in their reserves the new currency obtained through the sale of foreign bills against such exportations.

The process of transition is always one of the most delicate phases of the introduction of a new currency. It is because of the intricacies of the problem that the co-operation of the banks would be preferable in most cases to direct action by the government. All these problems, however, would be solved with equity and with comparatively little disturbance to business if the matter were entrusted to a strong bank which sought the services of competent experts. Within a very short period the transition was accomplished in the Philippines and in Mexico, without serious disturbance to business or to existing standards of wages and prices, and in both countries the system has been operated with such success, that a

[3]That they would not inevitably fall to this point is demonstrated by the present status of the Spanish silver coinage, which has an exchange value above 90, while the bullion value of the coins is below 50. Two factors contribute to this result,—the limited quantity of the coins and the possibility of the resumption of gold payments,—apart from intrinsic bullion value, which fixes for any given moment the minimum below which the exchange value of the coins cannot fall.

large surplus has been earned for the gold reserve fund from the sale of drafts and from interest on the deposit of the fund in foreign financial centers.

In both countries, while an ample local currency remains always in circulation, it responds in substantially the same automatic manner as a currency of gold and bank-notes to the changes in the demand for circulating capital and the movement of the foreign exchanges. This it does through the sale of drafts upon gold funds abroad and the temporary retirement of the currency thus employed, until it shall be called into use again by a counter-movement of the exchanges. In both countries the soundness and exchangeability of the currency is never called in question, and at the height of panic in New York in 1907 international bankers availed themselves of the financial tranquillity existing at Manila, to transfer funds to the beleaguered metropolis through the automatic working of the exchange fund, in order to mitigate the currency famine which had caused suspension of currency payments under the defective monetary system of North America.